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IN THE

Supreme Court of the United States

OCTOBER TERM, 1957.

No. 897

PELTON STEEL CASTING COMPANY,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT.

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PETITION FOR WRIT OF CERTIORARI.

To the Honorable the Chief Justice and Associate Justices of the Supreme Court of the United States:

Petitioner prays that a writ of certiorari issue to review the judgment of the Court of Appeals for the Seventh Circuit entered in the above case on January 7, 1958, affirming a decision of the Tax Court approving a determination of the Commissioner of Internal Revenue imposing a penalty tax under Section 102 of the Internal Revenue Code of 1939 for the year 1946 in the amount of $69,746.66.

CITATIONS TO OPINIONS BELOW.

The decision of the Tax Court is reported at 28 T. C. 153 (1957) and is printed in petitioner's appendix (p. 139) in the Court below now filed in this Court.

The opinion of the Seventh Circuit United States Court of Appeals is reported at ____ F. 2d ____ and is printed in the Appendix to this petition, pages 25 to 30.

JURISDICTION.

The judgment of the United States Court of Appeals for the Seventh Circuit was dated and entered on January 7, 1958. The jurisdiction of this Court is invoked under Title 28 U. S. C. Section 1254 (1).

QUESTIONS PRESENTED.

1. Is it a reasonable business purpose for a company to use all its available cash including maximum borrowings to buy in the stock of retiring officer-stockholders in order to forestall a sale to outsiders and thereby assure the preservation of the company's independence and its unique and successful operating policies?

2. Should Section 102 be construed to penalize a corporation for redeeming its own stock and thereby effecting the transfer of corporate control from retiring senior shareholders to the active management junior shareholder in contravention of the national policy to encourage the preservation of the independence of small business?

3. Where the cash distributed from the company's surplus to retire the stock imposes more income taxes on the recipients of the cash than would have resulted if the transaction had not been carried out, and instead the entire earnings had been divided in the form of dividends, should such distribution be deemed in violation of Section 102 as utilizing the corporation as a medium for "permitted earnings or profits to accumulate instead of being divided or distributed"?

4. Should the lower courts be permitted to disregard and render meaningless the burden of proof amendment of the new Section 534 which Congress was compelled to enact in order to achieve a fair administration of the penalty surtax?

STATUTES INVOLVED.

The statutes involved are Section 102 of the 1939 Code and Section 534 of the 1954 Code, the material portions of which are as follows:

"Sec. 102. *Surtax on Corporations Improperly Accumulating Surplus.*

"(a) Imposition of Tax.—There shall be levied, collected, and paid for each taxable year (in addition to other taxes imposed by this chapter) upon the net income of every corporation * * * if such corporation, however, created or organized, is formed or availed of for the purpose of preventing the imposition of the surtax upon its shareholders or the shareholders of any other corporation, through the medium of permitting earnings or profits to accumulate instead of being divided or distributed, a surtax equal to the sum of the following:

27½ per centum of the amount of the undistributed section 102 net income not in excess of $100,000, plus

38½ per centum of the undistributed section 102 net income in excess of $100,000.

* * * * *

"(c) Evidence Determinative of Purpose.—The fact that the earnings or profits of a corporation are permitted to accumulate beyond the reasonable needs of the business shall be determinative of the purpose to avoid surtax upon shareholders unless the corporation by the clear preponderance of the evidence shall prove to the contrary."

"Sec. 534. *Burden of Proof.*

"(a) General Rule.—In any proceeding before the Tax Court involving a notice of a deficiency based in whole or in part on the allegation that all or any part of the earnings and profits have been permitted to accumulate beyond the reasonable needs of the busi-

ness, the burden of proof with respect to such allegation shall—

(1) if notification has not been sent in accordance with subsection (b), be on the Secretary or his delegate, or

(2) if the taxpayer has submitted the statement described in subsection (c), be on the Secretary or his delegate with respect to the grounds set forth in such statement in accordance with the provisions of such subsection."

* * * * *

"Sec. 534(e) *Application of Section.*

(1) Notwithstanding any other provision of law, this section shall apply with respect to taxable years to which this subchapter applies and (except as provided in paragraph (2)) to taxable years to which the corresponding provisions of prior revenue laws apply.

(2) In the case of a notice of a deficiency for a taxable year to which this subchapter does not apply, this section shall apply only in the case of proceedings tried on the merits after the date of the enactment of this paragraph."

STATEMENT.

During the fiscal year ended November 30, 1946 the stock of Pelton Steel Casting Company was held in these proportions (Pet. App. p. 114):

Arthur J. Ehne	30%
Thomas L. Fawick	20%
Allen M. Slichter	20%

Ehne and Fawick desiring to retire, made sustained and active efforts to sell and were negotiating for the sale of the company to larger corporate interests (Pet. App. p. 133). Slichter had been the active manager of the company for both sales and operations and had developed uniquely successful sales and employee policies for the company. The finding of the Tax Court, as reiterated by the Court of Appeals, is

> "Slichter, who had made petitioner his life's work—developing close personal contacts with its customers and becoming largely responsible (especially after Leekley's withdrawal) for employee relations—was very concerned that petitioner might become a 'captive foundry' (viz., controlled by a large steel company, toward the filling of whose sole requirements its operation would then become devoted). He was also concerned about the attendant changes in the nature of its business (viz., the loss, in effect, of its corporate personality) as well as the possibly deleterious effects on employee relations and the status of 'key men' in the organization as it existed. Slichter did not like the idea of petitioner's becoming a subsidiary of some out-of-town corporation and of having his employee policies interfered with."

The price originally asked by Ehne and Fawick for their 80% of the stock was $1,200,000 in cash. As stated in the

above Finding, Slichter was greatly concerned with the preservation of the independence of Pelton, and its key employees, and the highly successful and unique operating policies, which he had developed, and considered to be his life work. As a result of a financing plan proposed by Pelton's banker, Ehne and Fawick agreed, before the end of the fiscal year 1946, to sell their stock to the company for such price, but one-third to be in preferred stock and only two-thirds in cash (Pet. App. pp. 134-36). They were thus to receive $400,000 preferred stock and $800,000 of cash, of which $300,000 was to come from the company's treasury and $500,000 was to be borrowed by the company on long term loan, provided always, of course, that Slichter could obtain the necessary loan for the company. Slichter set about vigorously before the end of the fiscal year (November 30, 1946) to locate a lender for the $500,000 to be borrowed.

Slichter was advised by the banker that pending securing such a loan the company should *not declare or pay any dividends or bonuses* or do any other act that would weaken it as a borrower (Pet. App. p. 136). The loan was regarded as "thin" and numerous banks and loaning institutions refused to make the loan for that reason. However, after some months of strenuous effort the company was finally able to secure the $500,000 loan, $300,000 from an insurance company and $200,000 from a bank. The Ehne-Fawick stock was purchased and retired in April 1947, thus averting a sale of the company to outside interests, and preserving the independence of Pelton (Pet. App. p. 137).

The capital gains tax which Mr. Ehne incurred on his share of the purchase price was approximately $150,000, as compared to the additional taxes of only $102,169.23 which he would have had to pay if the purchase transaction had

not gone through and instead the entire earnings for the year 1946 had been distributed by way of dividend.

In the trial before the Tax Court, except for the above computation, all the testimony presented was by witnesses for the taxpayer. It was the undisputed testimony of the financial experts that if any of the 1946 earnings had been paid out by way of dividend, this act would have been regarded by potential lenders as so improvident as to have disqualified Pelton from securing the necessary loan (Pet. App. pp. 57-8, 99-100). It was undisputed that the warning the banks had given to Slichter and Pelton that dividends should not be paid pending the obtaining of a loan was given, received and obeyed in complete good faith.

The Tax Court, notwithstanding the undisputed evidence on this point, held, and the Seventh Circuit affirmed, that the paying out of all the company's available cash plus the $500,000 it had to borrow to retire the Ehne-Fawick stock was not for a reasonable busines purpose. In fact, they held it was not even a "valid" business purpose.

REASONS FOR GRANTING THE WRIT.

1. The Decision Below Is in Direct Conflict With the Rule Previously Adopted by the Third Circuit and All Other Decisions That the Use of Corporate Funds to Maintain Corporate Existence and Independence Is a Valid and Reasonable Business Purpose.

The major and overriding question of this case is whether the purchase of the Ehne and Fawick stock accomplished a "business purpose". If so, there can be no violation of Section 102. The question of whether a particular course of conduct qualifies as being pursuant to business purpose is one frequently arising in the corporate tax field.

Perhaps more than in any other facet of the tax law, the development of the concept of business purpose has been the particular province of this Court. Unlike the usual technical tax questions, the business purpose tests involve interpretations of statutory provisions and development of general rules of law.

Thus the taxpayers and businessmen, concerned with business purpose at a very practical level, depend upon this Court to furnish the lead in developing and shaping the business purpose boundaries. This need of clarification may arise even in situations where the lower courts are in agreement. Clarification becomes a necessity where conflicts exist in the lower courts. This is such a situation.

The decision of the Seventh Circuit that the accumulation of cash by a company to buy out the stock of retiring key employees is not a valid business purpose, is directly in conflict with the rule on the same subject as announced by the Third Circuit in the case of *Emeloid Co.* v. *Com-*

missioner, 189 F. (2) 230 (CA-3, 1951). While that case did not arise under Section 102, it involves the same issue of whether the utilization of company funds to redeem the stock of stockholders who might die is a valid business purpose. In *Emeloid* the Tax Court had held that the borrowing of funds to purchase insurance to provide for the purchase of stock of a deceased stockholder was "to further the personal interests" of the remaining shareholders-officers and termed the benefit to the corporation as "highly remote." The Commissioner then contended that the borrowed money not having been used for a business purpose, the loan could not be considered in computing the company's excess profits credit. The Third Circuit however, reversed, stating that the entire insurance arrangement was intended to provide for the "continuity of harmonious management" and that the borrowing of money to pay premiums to enable the company to buy out the stock of a deceased stockholder was a valid business purpose. It specifically said that the maintenance of harmonious management and the continuance of the enterprise was a proper corporate purpose. The fact that the funds were first used to buy insurance, which was in turn to be used to purchase the stock of a deceased employee, was merely a method of having the cash ready at the time needed. The principle announced is indistinguishable from petitioner's position in this case, namely that the utilization of corporate funds to redeem the stock of key retiring employees is a valid company purpose, and the fact that it places the junior employees in control and may eventually prove to be to their benefit does not make it any the less a reasonable business purpose when it aided in the continuance and independence of the business.

The decision of the Seventh Circuit is also directly in conflict with the only other case on the redemption question arising in either the United States District Courts or

Circuit Courts of Appeal. We refer to *Gazette Publishing Co.* v. *Self* (E. D., Ark. 1952), 103 F. Supp. 779. In that case petitioner published a successful and highly regarded newspaper. Over the years it built up a harmonious organization dedicated to retaining the paper's moral integrity, and it had, like Pelton, long established and successful business policies. The corporation's secretary, general manager and a large stockholder (Allsopp) died in 1946. His son, who succeeded him, became violently estranged from management in 1948. He placed a premium price on his stock, coupling this with the threat to sell out to unnamed "outsiders" unless the corporation met his price. In the minds of management (and of the Court) this possibility posed a major danger to the policies of the company, even though it constituted a minority of all the stock. The following expression is worthy of particular note:

> [103 F. Supp. 784]
>
> "* * * For this Allsopp stock to have fallen into the hands of some special interest antagonistic to the present and the general policy of the paper, could and probably would have been most disruptive of the harmony of the corporation, even though it constituted a minority of all the stock. *The purchase of this stock, even at the advanced price paid, was a reasonable need of the corporation, and was a change in circumstances which fully justified a change in the use of funds accumulated for other needs, and justified the borrowing of the $600,000 in addition to using the funds on hand.*" (Emphasis supplied.)

The parallel of that approach to the facts here presented is so apparent as to require little discussion. Suffice it to note that the Court held that the buying in of the minority Gazette stock to insure it not falling into the hands of outside interests was a completely justified and reasonable business purpose, which is directly contrary to the holding

in the *Pelton* case. We might here comment that if the buying in of the minority stock to prevent it falling into the hands of outsiders was a reasonable purpose, obviously the danger of disruption would be greatly multiplied where, as here, the majority interest was in danger of being acquired by outside interests.

The Tax Court itself had passed on an almost identical case in *Dill Manufacturing Co.*, 39 BTA 1023 (1939). In that case the operating group owned 50.02% and certain inactive investors owned 49.98% of the Dill Manufacturing common stock. The non-operating portion of the stockholders desired to sell the business or merge it with a larger concern. The operating group opposed this and an arrangement was then worked out under which the company utilized all its available cash and major borrowed funds, in amounts remarkably similar to the ones in the instant case, to buy out the non-operating stockholders. The Commissioner claimed that this was a private purpose, but the Tax Court had no difficulty in finding that the company constituted the life work of its operating officers and that "the protection of the economic and financial independence of that work was scarcely less warranted as a business purpose than if petitioner had been an individual."

Thus, the *Emeloid* case from the Third Circuit, the *Gazette* case from the United States District Court of Arkansas and the *Dill* case from the Tax Court all find that the utilization of company funds to buy out a retiring group of stockholders and to continue the independence of the business enterprise is a "reasonable business necessity." These are the only decided cases which discuss the point and all are in conflict with the Seventh Circuit decision.

The Seventh Circuit ignores *Emeloid* and attempts to

distinguish the *Gazette* and *Dill* cases on the ground that here a majority was bought out while in the *Dill* and *Gazette* cases a minority was purchased. The distinction is obviously unsound. In the *Dill* and *Gazette* cases, the minority group could have made the business life of those companies unhappy but they could not have compelled the selling out of corporate control to others. In this case, the threat of relinquishing control to outsiders was very real in the Ehne and Fawick, owning 80% of the stock, had the power to sell control to outsiders, and only by the company buying them out could the preservation of the independence of Pelton be assured. In the *Dill* and *Gazette* cases it took the concurrence of both the selling out minority and the buying out majority to effect the result. In the *Pelton* case it likewise took the concurrence of the sellers Ehne and Fawick and inescapably also of the remaining stockholder, Slichter, to effect the result. In other words, in the three cases all parties as a practical matter had to agree. In all three cases, the most recent earnings of the companies were paid out presumably to be taxed to the sellers on a capital gains basis. The contention that the cases differ because in *Pelton* a majority was involved, which had the full power to terminate Pelton's independence by selling the company to an outsider, is really a distinction in reverse as the business purpose of buying out the retiring stockholder's stock becomes all the more valid when it is the only sure way to preserve the company's independent existence.

2. The Decision Below Contravenes Well Established National Policy and Thereby Raises an Important Question of Federal Law Which Has Not Been But Should Be Settled by This Court.

The Seventh Circuit held that the devotion of a small company's assets (including its most recent earnings) to the purchase of a retiring stockholder's stock interest was not for a reasonable or valid business purpose, even though the purchase was necessary to preserve the company's independence. This holding is in direct derogation of the well established national policy to preserve and encourage the preservation of small business enterprises.

For generations small enterprises have been confronted with the difficult problem of succession when senior owners desire to retire and to turn over their business interests to their younger associates. This problem plagues both partnerships and smaller corporations whose stock is not listed. The younger partners or associates as in Pelton will many times not be able to finance personally the purchase of the interest of retiring partners or owners and it has been a conventional, normal and highly approved practice for the partnership itself to buy out the retiring partners, or for the closed corporation itself to buy out the retiring key employees and owners who desire to retire and sell out at the same time. The use of insurance to provide for the implementation of "buy and sell" agreements is very frequent but is no solution where as in *Pelton* and *Gazette, supra,* there is an imminent threat of a sell out to outsiders. Sometimes the redemption arrangements will be set up long in advance in formal "buy and sell" agreements; sometimes they are worked out only when the occasion arises, as was the situation in the *Pelton* case.

We submit that this practice is normal and is obviously socially and economically desirable. Not one breath of a

suggestion has ever been made in the long congressional history of Section 102 that this Section should or could be applied to impede the use of "buy and sell" agreements by penalizing the company if any of the recent earnings are used for this highly important purpose rather than being paid out as dividends.

The very usual situation in a closely held company is for the retiring senior officer, as in Pelton, to own at least half, or even likely more than half, of the stock. The carrying out of a "buy and sell" arrangement will generally involve a considerable sum, requiring use of not only the liquid resources of the company but in addition, funds secured through sizeable loans. In the *Emeloid*, *Gazette* and *Dill* cases, as well as in *Pelton*, sizeable loans were required. The declaration of a dividend immediately prior to application to potential lenders for a major term loan would be obviously improvident and would disqualify the borrower as a prudent risk, just as the financiers testified without contradiction in the *Pelton* case. The effect of the Seventh Circuit decision is that one must choose between a buy and sell arrangement and a dividend, with the result that a retiring stockholder must necessarily look only to outsiders such as larger corporations as potential buyers. Thus the Seventh Circuit doctrine has created a new and most serious roadblock to preserving the independence of small enterprises and develops a further incentive to concentration.

It would seem strange to argue that Congress should have intended by the use of Section 102 to impede the process of retiring officer-stockholders selling out to the closed corporation and thereby arranging the full succession of both management and ownership to their younger associates. The Commissioner in this case is making an argument, which the Seventh Circuit sustains, that the preservation of a small business is not even a valid business

objective. We submit that for this reason alone this Court should take jurisdiction.

The doctrine of the Seventh Circuit is contrary to the avowed national policy of Congress and all recent past administrations of the United States to preserve the independence of small businesses. The Congress of the United States through many successive sessions has recognized the importance of preserving small business, and to that end has created Committees on Small Business in both Senate and House, who are continually studying the problems and handicaps of small business.

The Senate Judiciary Committee through its Subcommittee on Anti-trust and Monopoly has been for some years in almost continuous study of "Bigness and Concentration of Economic Power." Congress enacted special legislation in 1953 creating a Small Business Administration, so as to enable small businesses to obtain aids and financing where it will tend to preserve their independence and soundness. (Small Business Act of 1953, Public Law 163.) Much legislation has been enacted to protect small business such as the Robinson-Patman Act and amendments to Section 7 of the Clayton Act.

The Federal Trade Commission is busily devoting a very major part of its activities to the question of the dangers to American business through concentration. It has published a number of studies on the subject. It views with alarm the growing tendency of concentration and the importance of preserving the healthy competitive condition that all recognize follows from the maintenance of small independent companies. The Department of Justice through many administrations has also devoted a major part of its activities and energy in endeavoring to break up and prevent concentration in American industry. For the last twenty-five years at least the Presidents of the United

States have addressed Congress from time to time on the importance of lightening the burdens on small business. (See for example President Eisenhower's Economic Report of January 20, 1958, and Budget Message of January 16, 1957.)

So far as we know, the Commissioner of Internal Revenue is the only functionary of the United States who disagrees with the doctrine that the maintaining of the independence of a small business is a valid business purpose. It is therefore surprisingly strange that in this case the Seventh Circuit should align itself with the view that the preservation of Pelton as an independent company was not a "valid" or reasonable business purpose, particularly where the policies of Pelton, which had been both unique and successful, could only be surely protected by the buy and sell arrangement worked out between Ehne, Fawick and the petitioner.

We submit that if this case stands unreversed it will throw a cloud on the usual "buy and sell" arrangements and engender a sense of cynicism when hereafter the Attorney General or Federal Trade Commission in other cases and other situations may attempt to claim that they are pursuing a sound national policy in favoring the independence of small businesses and in regarding the ever-increasing concentration of American business as a danger to our basic economy.

3. Although the Seventh Circuit Conceded That a Division or Distribution of Earnings Is a Complete Defense to the Section 102 Penalties, It Committed a Fatal Mistake of Law When It Completely Disregarded the Fact That Petitioner Here Made a Distribution Far in Excess of the 1946 Earnings and Thereby Precluded Application of Section 102.

The construction given by the Court to Section 102 is contrary to its direct language. Hence another important question of law is raised which should be decided by this Court.

The Statute applies the penalty tax where a corporation is "formed or availed for the purpose of preventing the imposition of the surtax upon its shareholders * * * by permitting earnings or profits to accumulate instead of being *divided or distributed.*" (Emphasis supplied.) Thus, if earnings are "divided or distributed" instead of being accumulated, the Section 102 penalty surtax cannot apply.

The Statute does not say that the only method of dividing or distributing is through "ordinary dividends." If it had so meant, other language would certainly have been used instead of "divided or distributed." The buying out of Fawick and Ehne resulted in this small company distributing out by way of a partial liquidation $800,000 of cash as well as the $400,000 of preferred stock. This was a *distribution* of cash four times larger than would have been effected if the entire earnings of 1946 had been paid out by way of ordinary dividend. As set out above, the consequent income taxes created by this transaction to Mr. Ehne (the retiring 60% stockholder) far exceeded the income taxes that would have been paid by him if the transaction had not taken place, and instead the full year's earnings had been paid out by way of ordinary dividend. The Court has entirely glided by the words "divided or

distributed". Certainly when a company distributes $800,000 of cash by way of partial liquidation resulting in extremely high taxes to the recipients, how can it be claimed that the stockholders were intending to use the company as a medium to prevent the imposition of surtax particularly where the statute specifically precludes the application of Section 102 where the funds are "divided or distributed"? The construction by the Seventh Circuit completely reads out of the statute the important words "or distributed" and makes them meaningless.

It is submitted that this construction violates a fundamental rule, namely, that all the words of a statute must be given effect. When this eminently sensible business arrangement is termed a corporate device even though it exposed the so-called beneficiaries of the device to terrifically high taxes, the statutory exemption inherent in the word "distributed" is ignored.

If this decision be sustained there will inevitably be a plethora of cases where the Commissioner will contend that any utilization of company funds other than for the payment of dividends and perhaps for immediate capital expenditures is a mere device to prevent the imposition of surtax.

If the situation such as in the *Pelton* case, where tremendously higher income taxes resulted to the recipients than if the entire earnings had been paid out by way of dividends, is to be called a mere device to prevent the imposition of surtaxes, the the entire section will become highly fluid and businessmen will not know until too late that what they thought was a valid and reasonable business purpose will be regarded by the Commissioner and perhaps the Courts as a mere device. Review in the instant case will have a controlling effect on the many other cases pending in the Courts in the interpretation and application of Section 102.

4. The Lower Courts Have Destroyed and Rendered Meaningless the New Section 534 Remedial Amendment, Shifting the Burden of Proof to the Commissioner in Section 102 Cases.

Section 534 was enacted in 1954 as an amendment to Section 102 of the 1939 Code, and was made effective to pending cases by Section 534 (c), 1954 Code. In clear and unequivocal language it placed upon the Commissioner the burden of proving that the accumulation of surplus was in excess of reasonable business needs. This amendment changed the law which had imposed upon the taxpayer the burden of showing reasonableness.

The Commissioner's Notice of Deficiency to Petitioner was issued prior to 1954 (Pet. App. p. 7). Following enactment of Section 534, however, the Commissioner complied with the procedure therein set forth by formally notifying Petitioner that the notice of deficiency involved a Section 102 improper accumulation and that Petitioner had thirty days to submit facts establishing the reasonableness of the surplus (Pet. App. p. 18). Petitioner timely filed the required Statement (Pet. App. p. 20). Subsequently, in his answer to the amended petition, the Commissioner controverted Petitioner's statement and alleged the accumulations were in excess of reasonable needs of Petitioner's business. There is no doubt that the issue of the reasonableness of the accumulations was properly before the Court.

Section 534 was enacted by Congress to halt the Commissioner's indiscriminate assertion of deficiencies under Section 102 and the flood of cases set up by his agents. The coercive effect of Section 102, especially when applied to small corporate taxpayers such as Petitioner, necessitated [illegible]etic change in the operation and administration of this Section. The abuses and inequities which Section

534 was designed to rectify are clearly set forth in the report by the Senate Finance Committee accompanying the proposed amendment.

> "Your committee agrees with the House that this imposition of the burden of proof on the taxpayer has had several undesirable consequences. The poor record of the Government in the litigated cases in this area indicates that deficiencies have been asserted in many cases which were not adequately screened or analysed. At the same time taxpayers were put to substantial expense and effort in proving that the accumulation was for the reasonable needs of the business. Moreover, the complaints of taxpayers that the tax is used as a threat by revenue agents to induce settlement on other issues appear to have a connection with the burden of proof which the taxpayer is required to assume. It also appears probable that many small taxpayers may have yielded to a proposed deficiency because of the expense and difficulty of litigating their case under the present rules." (S. Rep. No. 1622, 83rd Cong., 2d Sess. p. 70.)

Congress was, of course, aware that the purpose of Section 102 was to penalize corporations which unreasonably accumulated earnings. As stated by this Court:

> "As the theory of the revenue acts has been to tax corporate profits to the corporation, and their receipt only when distributed to the stockholders, *the purpose of the legislation is to compel the company to distribute any profits not needed for the conduct of its business* so that when so distributed, individual stockholders will become liable not only for normal, but for surtax on the dividends received." (Emphasis supplied.) *Helvering* v. *Chicago Stock Yards Co.*, 318 U. S. 693, 699, 63 S. Ct. 875, 876 (1943).

The test in Section 102 cases, except where investment or holding companies were involved, was the reasonableness of the accumulations. Congress likewise recognized, as the above excerpt from the 1954 Senate Report discloses,

that the Commissioner's principal weapon in Section 102 cases was the use of a presumption arising from the taxpayer's failure to discharge its burden of proving reasonable accumulations. Congress, therefore, decided the most effective remedy was to shift this burden of proof. Congress deliberately undertook to stop the abusive use of Section 102 by forcing the Commissioner to show the surplus was in excess of reasonable business needs.

The intention of the framers, in this regard, is most clearly evidenced in the Report of the House Ways and Means Committee to a 1948 Bill which, although failing of enactment, served as a practically verbatim basis for the 1954 amendment:

> "Your committee's bill (Sec. 125) contains three amendments to Section 102, designed to reduce the pressure on taxpayers to distribute earnings needed for real business purposes, and to remove some of the harsher aspects of the tax treatment under this provision. The provisions, however, do not prevent the functioning of this tax as a safeguard against the improper accumulations of surplus."
>
> "The first amendment places on the Commissioner of Internal Revenue in certain cases the burden of proving that an accumulation of earnings and profits is beyond the reasonable needs of the business. However, to shift the burden of proof in this fashion, the taxpayer, having received notice from the Commissioner, must file a statement indicating the reasons why the needs of the business require such retention. If the taxpayer does not file such a statement, or presents additional grounds, he must bear the entire burden of proof as under existing law. If the Commissioner fails to give the taxpayer proper notice, then the Commissioner must bear the burden of proof even though the taxpayer has filed no statement. *This provision is designed to assure the taxpayer that the penalty tax will be imposed only where there is proof of an improper accumulation of surplus.*" (Emphasis supplied.) H. Rep. No. 2087, 80th Cong. 2d Sess. pp. 8-9.

The Tax Court, however, refused to heed the Congressional directive that the Commissioner prove the unreasonableness of the accumulations, even though the Commissioner admitted in his Tax Court brief that Petitioner had complied with the statutory requirements to shift the burden. It held that Section 534 was of no effect in the instant case and, thus the taxpayer was forced to assume the burden of showing the reasonableness of its surplus. The Seventh Circuit affirmed, without mention of this issue, despite the vigorous protestations of the Petitioner below.

The Tax Court completely ignored and defeated the Congressional intent by a construction of Section 534 which renders it applicable only where the Commissioner specifically alleges an "unreasonable accumulation" in his statutory Notice of Deficiency. The Senate Finance Committee, in its Report to the 1954 Bill, *supra*, made it clear, however, that "the shift in the burden of proof under Section 534" applied wherever "the issue between the Government and the taxpayer relates to the portion of the earnings and profits which may be accumulated during the taxable year for the reasonable needs of the business". The sole point in issue in the instant case was the "reasonableness" of the accumulation in light of the Petitioner's proposed use of the surplus.

This case is the first to be tried under and presenting the issue of the application and effect of the 1954 Amendment. The legal question involved has, of course, never been passed upon by this Court. The construction of the amendment is of paramount importance as it will affect every future accumulated earnings tax under Section 531 *et seq.* of the 1954 Code and in many cases it will be the determining factor. The question should, we think, be decided by the Court because of its vital importance in the proper administration of the tax laws, and because

the decision, if permitted to stand, renders meaningless a significant statute which Congress was compelled to enact to accomplish a fair administration of Section 102 and the penalty tax.

CONCLUSION.

For the foregoing reasons, this petition for a writ of certiorari should be granted.

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Counsel for Petitioner.

APPENDIX.

IN THE UNITED STATES COURT OF APPEALS

For the Seventh Circuit.

No. 12107. September Term and Session, 1957.

PELTON STEEL CASTING CO., *Petitioner,*
vs.
COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

Petition for Review of Decision of the Tax Court of the United States.

January 7, 1958.

Before FINNEGAN, SCHNACKENBERG and PARKINSON, *Circuit Judges.*

FINNEGAN, *Circuit Judge.* Section 102(a) of the Internal Revenue Code of 1939, as amended, 55 Stat. 687, 26 U. S. C. § 102 (1952 ed.) imposed a surtax on corporations improperly accumulating surplus. The respondent Commissioner decided that Pelton Steel Casting Co., petitioner, was availed of in 1946 for the purpose of preventing the imposition of such surtax upon its shareholders by accumulating the corporate earnings and profits instead of dividing or distributing them. That determination of the Commissioner covered fiscal years ending November 30, 1945 and November 30, 1946; penalty tax for 1945 was $12,214.22 and for 1946, $69,746.66. The Commissioner conceded there was no deficiency for the year 1945. We have before us for review the Tax Court's lengthy opinion, reported as *Pelton Steel Casting Co.* v. *Commissioner*

of Internal Revenue, 28 T. C. No. 20 (1957), approving the 1946 penalty tax, and resting in considerable part on stipulated facts. Detailing of the operative facts is obviated by their presentation in the opinion issued by the Tax Court, and for that reason we merely describe the factual situation.

During its fiscal year 1946 Pelton had earnings and profits of $209,731.58 and its common stock was held, in these proportions, by Ehne—60%, Fawick—20% and, Slichter—20%. When Ehne and Fawick informed Slichter of their mutual desire to sell Pelton, Slichter decided to avert an outside sale. After Slichter consulted a banker and lawyer the three stockholders agreed on November 11, 1946, that the corporation would buy up and redeem 80% of the common stock held by Ehne and Fawick at their price of $1,200,000 (this being 80% of $1,500,000, the selling price of the Pelton assets when offered to outsiders). Under the plan Ehne and Fawick were to receive $800,000 in cash and $400,000 in Pelton preferred stock. That cash flowed from two sources: (1) $300,000 was Pelton's own money and, (2) $500,000 was borrowed by Pelton on a 10-year agreement, dated April 17, 1947, under which an insurance company covered $300,000 to mature in the last six years, and Pelton's bank covered $200,000 to mature during the first four years. This loan, secured by a mortgage on Pelton's plant, was made May 31, 1947, the date when Slichter became the sole common stockholder as the result of the sale-redemption arrangement of 80% of the outstanding common stock held by Ehne and Fawick. Ehne's preferred stock, newly issued to him under the above plan, was immediately purchased by Slichter who gave Ehne a 20-year installment note.

Financiers planning Pelton's purchase of the common stock advised against declaration and payment of dividends during 1946. Again, to repeat for emphasis, it is the Tax Court's opinion which contains recitals of pertinent facts and reproduces the relevant financial statements. On the other hand, this record clearly establishes Pelton as a closely held corporation whose three director stockholders did not receive 1946 dividends.

An interesting sidelight here comes from the Tax Court opinion:

> "The respective amounts of the personal income tax actually paid by A. J. Ehne for 1946 and the estimated amount of tax for which he would have been liable had all of the 1946 earnings and profits (209,731.58) been distributed in the form of a dividend in that year and had his 60 per cent thereof (some $126,000) in addition to his other income for that year ($47,063.93, per his tax return) been taxed to him at ordinary income rates, are as follows:

Actual	Estimated	Estimated difference
$22,786.73	$124,955.96	$102,169.23

> The tax paid by A. J. Ehne in 1947 on the $603,571 gain realized under the plan on the retirement of his interest in petitioner under the elective alternative tax rates in effect was approximately $150,000. . . ."

The inference, of course, is that instead of dividing all or a portion of the 1946 earnings and profits, totaling $209,731.58, Ehne, Fawick and Slichter countenanced that accumulation and then plowed these earnings into redemption of the common stock. Such an inference is within respectable bounds of reasoning on the evidence before us. On the other hand, Pelton strives to cancel out that inference, and indeed any violation of § 102, by pressing on us, as it did the Tax Court, Slichter's undiminished efforts to preserve Pelton's independent existence. In short, the evidence shows that Slichter envisaged Ehne and Fawick selling Pelton to a corporate cannibal; consequently, complete control through the reorganization plan, already described, of Pelton by Slichter loomed up as the only salvation. That reorganization was rejected by the Tax Court on the grounds that it was not promoted for a valid business purpose.

Clearly the batch of ideas sponsored on Pelton's behalf fails in hurdling this passage in § 102, as amended: "There shall be levied, collected, and paid for each taxable year . . . upon the net income of every corporation . . . if such corporation . . . is . . . *availed* of for the

purpose of preventing the imposition of the surtax upon its shareholders . . . *through the medium of permitting earnings or profits to accumulate* instead of being divided or distributed. . . .'' Obviously, the fact an accumulation existed, in Pelton's case, is uncontroverted, and its appeal simply urges that the accumulation was not the type or class penalized by § 102.

Regardless of how Pelton's propositions raised in this appeal are analyzed they recur to the basic theme of "reasonable business needs." But what Chief Judge Magruder wrote for the court about *Helvering* v. *Chicago Stock Yards Co.*, 318 U. S. 693 (1943) in the course of the opinion[1] reported as *Latchis Theatres of Keene* v. *Commissioner*, 214 F. 2d 834, 835 (1st Cir. 1954) is both incisive and relevant here. ". . . when the record contained substantial evidence to support the ultimate inference by the Board of Tax Appeals that corporate profits had been accumulated for the forbidden purpose, the reviewing court had better not disturb the decision of the Board of Tax Appeals (now the Tax Court of the United States); it had better forego any finicky refinements in an examination of the subsidiary steps, the mental processes, by which the Board of Tax Appeals arrived at its ultimate finding of fact. Since then, by the 1948 amendment to § 1141(a) of the Internal Revenue Code, 62 Stat. 991, the scope of our review of findings of the Tax Court has been made the same as our review of findings of the district courts in civil actions tried without a jury; that is, the Tax Court's findings of fact cannot be set aside 'unless clearly erroneous.'"

Dill Manufacturing Co. v. *Commissioner*, 39 BTA 1023 (1939) and *Gazette Publishing Co.* v. *Self*, 103 F. Supp. 779 (D. C. Ark. 1952) are the two main props erected by Pelton's counsel when contending that the reorganization plan was a valid business purpose outside the ambit of § 102. But reliance on those two cases is misplaced by overlooking the fact that the Pelton plan required, and had, unanimous stockholder approval. The actuality

1. *McCutchin Drilling Co.* v. *Commissioner*, 143 F. 2d 480 (5th Cir., 1944); *Trico Products Corp.* v. *McGowan*, 169 F. 2d 343 (2nd Cir. 1948).

of the consummated plan could only be reached, and was achieved, by the favorable vote of Ehne, alone, or in combination with Fawick. Both *Dill* and *Gazette* are instances where the majority of shareholders bought out a minority, and to that extent *Pelton*, *Dill* and *Gazette* are all cases where the majority (at bar Ehne, Fawick and Slichter) of stockholders acted, but only in Pelton did a minority stockholder remain in the corporation, after the majority sold out and all three men enjoyed the tax benefit of the planned action. Congress, when it was considering provisions corresponding to § 102 in the Bill that culminated in the Internal Revenue Code of 1954, pointed up the difficulties implicit in delineating proscribed accumulations:

> "One of the principal reasons for confusion as to application of the section 102 tax has been the lack of adequate standards as to what constitutes the reasonable needs of the business. Some of the standards informally employed in the past, such as the distribution of 70 per cent of earnings, have been erroneous or irrelevant. More often, in the absence of adequate guidance, revenue agents in examining cases have applied their individual concepts as to business needs.
>
> "As a result some improper criteria developed which have led to criticism of the tax on unreasonable accumulations. One such principle is the so-called immediacy test, under which there must be an immediate need for the funds in order to justify the retention of earnings. In some cases section 102 was applied even though the corporation had definite plans for expansion and the *bona fides* of the expansion program were not in question.
>
> "In order to eliminate the immediacy test, both the House and your committee have expressly provided in the statute that the reasonable needs of the business shall include the 'reasonably anticipated' needs of the business. It is contemplated that this amendment will cover the case where the taxpayer has specific and definite plans for acquisition of buildings or equipment for use in the business. It would

not apply where the future plans are vague and indefinite, or where execution of the plans is postponed indefinitely." Sen. Rep. No. 1622, 83d Cong. 2d Sess. 69 (1954).

Slichter's testimony in the Tax Court demonstrates that Ehne, especially, and Fawick wanted to sell Pelton. Representing 80% of the outstanding capital, as these two men did, they could have ended the independent existence of Pelton. All Slichter's action and motivation[2] indicates is a vague sort of moral obligation toward faithful employees and some understandable pride in perpetuating Pelton as a separate entity. Ransoming Pelton was apparently far from the evidenced state of mind attributable to Ehne or Fawick.

Section 102, containing as it did penalty provisions, was intended as a deterrent. Its aim was to prevent the corporation from being used as a device for avoiding surtax on individual incomes. The singular feature, frequently and conveniently overlooked, is that the penalty tax may be avoided by distributing earnings. See *e.g.* Carey, Accumulations Beyond The Reasonable Needs Of The Business: The Dilemma Of Section 102(c), 60 Harv. L. Rev. 1282 (1947). The record is utterly devoid of countervailing evidence either palliating or eradicating the situation interdicted by § 102, indeed we are satisfied Pelton was "availed of" during the taxable year.

The judgment of the Tax Court is

AFFIRMED.

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2. See *e.g.* 28 T. C. No. 20 at page 15: "Slichter, who had made petitioner his life's work—developing close personal contacts with its customers and becoming largely responsible (especially after Leckley's withdrawal) for employee relations—was very concerned that petitioner might become a 'captive foundry' (*viz.*, controlled by a large steel company, toward the filling of whose sole requirements its operation would then become devoted). He was also concerned about the attendant changes in the nature of its business (*viz.*, the loss, in effect, of its corporate personality) as well as the possibly deleterious effects on employee relations and the status of 'key men' in the organization as it existed. Slichter did not like the idea of petitioner's becoming a subsidiary of some out-of-town corporation and of having his employee policies interfered with."